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Magalie Roman Salas  
Office of the Secretary  
Federal Communications Commission  
Room TW-B204  
445 12<sup>th</sup> Street, SW  
Washington, DC 20554

Dear Secretary Salas:

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of regulations and their impacts on society. As part of its mission, RSP produces careful and independent analyses of agency rulemaking proposals from the perspective of the public interest. Thus, the program's comments on the Federal Communications Commission's Notice of Inquiry on high-speed access to the Internet over cable and other facilities, do not represent the views of any particular affected party or special interest group, but are designed to protect the interests of American citizens.

The Regulatory Studies Program appreciates the opportunity to comment on the Federal Communications Commission's Notice of Inquiry. We hope that consideration of these comments will enhance the quality and development of regulations and policy regarding broadband open access.

Wendy L. Gramm, Director  
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enclosure

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MERCATUS CENTER  
REGULATORY STUDIES PROGRAM

**Public Interest Comment on**

**The Federal Communications Commission's Notice of Inquiry on  
High-Speed Access to the Internet Over Cable and Other Facilities<sup>1</sup>**

GN Docket No. 00-185

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The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP employs contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, our response to the Federal Communications Commission's Notice of Inquiry regarding broadband open access does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of mandatory open access on overall consumer welfare.

The fundamental question raised by the Commission's Notice of Inquiry is whether the Commission should continue the market-based approach to open access it has employed in regard to cable broadband, or intervene to require some form of open access. A thicket of legal points surrounds this question, but the Notice of Inquiry also raises several economic issues. RSP's economic analysis suggests that continuation of the Commission's market-based approach to open access will best promote consumer welfare. In theory, open access mandates can improve consumer welfare when the facilities subject to the mandate are monopolized. The broadband market, however, is anything but a monopoly, and so there is no consumer welfare justification for imposing open access in broadband. Consumers would be even better off if the Commission applied the same market-based approach to all broadband technologies.

**I. Summary of Mercatus Analysis**

We offer comments on four principal issues raised in the Notice of Inquiry:

1. **What is "open access?"** "Open access" could mean either that the broadband customer has access to all Internet Service Providers' content, or that the customer can choose which ISP will connect the broadband provider's local facilities to the internet backbone. The first type of open access already exists. The second could arise either as a result of voluntary negotiations or several different regulatory models.

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<sup>1</sup>Prepared by Jerry Ellig, Ph.D. Dr. Ellig is a Senior Research Fellow at the Mercatus Center at George Mason University. The views expressed herein do not reflect an official position of George Mason University.

2. **Is open access a desirable policy goal?** The appropriate criterion for answering this question is consumer welfare. The most honest answer to the question is that no one knows for sure whether open access will maximize consumer welfare. Fortunately, competition in the broadband market will ensure that whatever business model wins out will be that which consumers prefer.
3. **Is the Commission's market-based approach toward open access appropriate?** Yes. The broadband market is quite young, but competition is robust. The Commission's market-based approach has been and remains appropriate.
4. **Is a uniform regulatory framework desirable?** Uniform application of the Commission's market-based approach to all broadband providers, including incumbent local exchange carriers offering digital subscriber line service, is most appropriate.

## II. Background

The market for broadband Internet service is growing rapidly but still in its infancy. Between 1998 and June 2000, the number of broadband subscribers grew more than ten-fold, from 375,000 to 4.3 million.<sup>2</sup> Yet even the 2000 figure is small in comparison to the approximately 40 million subscribers to dialup Internet service.<sup>3</sup>

Thus far, the Commission has taken a market-based approach to open access for cable, satellite, and wireless broadband, declining to impose regulations that would require open access.<sup>4</sup> This approach reflects a sound understanding of marketplace dynamics. Imposing economic regulation on such a young, rapidly-changing market runs the risk of discouraging investment and diverting firms' energies from rolling out service to fighting each other in the regulatory forum. In addition, there is little evidence of monopoly that might justify such regulation. Under such circumstances, restraint is the appropriate course of action.

The Commission has taken a more activist stance in regard to broadband offered by incumbent local exchange carriers who provide digital subscriber line (DSL) service, mandating that these companies allow competitors to collocate equipment on or near their central offices, offer DSL at a wholesale discount to competitors, and share local DSL

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<sup>2</sup> Federal Communications Commission, *Broadband Report 1999*, CC Docket No. 98-146 (January 28, 1999) [hereafter referred to as *Broadband Report 1999*]; Federal Communications Commission, *Deployment of Advanced Telecommunications Capability: Second Report*, CC. Docket 98-146 (August 2000) [hereafter referred to as *Second Report*]; Federal Communications Commission, *High-Speed Services for Internet Access: Subscribership as of June 30, 2000* (October, 2000) [hereafter referred to as *High-Speed Services Report*].

<sup>3</sup> Jeffrey Eisenach, Thomas Lenard, and Stephen McGonegal, *The Digital Economy Fact Book*, 2<sup>nd</sup> Edition (Washington: Progress and Freedom Foundation, 2000), p. 19.

<sup>4</sup> *Notice of Inquiry*, para. 43.

lines with competitors.<sup>5</sup> Local phone companies are also prohibited from discriminating against independent ISPs.

The open access debate provides the Commission with a clear choice between two competing paradigms: the old paradigm of monopoly regulation or the new paradigm of competition. To assist the Commission in its choice, RSP offers comments on several of the issues raised in the Notice of Inquiry, including the meaning of open access, the desirability of open access as a policy goal, and the appropriateness of the Commission's market-based approach. As requested, we discuss these issues in the same order that they are raised in the Notice of Inquiry.

### **III. What is "open access?"**

This is a foundational issue, and the answer is not at all clear. It can best be approached by first asking exactly what services ISPs sell that customers might want to access.

#### **A. What are customers buying from ISPs?**

Traditionally, ISPs have sold three services: dial-up connection through conventional telephone lines, connection from the local telephone company's facilities to the Internet, and proprietary content. In broadband, the dial-up connection is unnecessary, since broadband Internet service is "always on." ISPs could, however, still offer the other two services to broadband subscribers. An independent ISP could connect the cable or other broadband provider's local plant to the Internet, and ISPs could still offer proprietary content.

In this environment, open access could mean access to ISPs' proprietary content, choice of which ISP will connect the local broadband plant to the Internet, or both.

##### **1. Access to content**

Open access to content means that all broadband customers have the ability to reach any ISP's proprietary content. This form of open access already exists.

Like other Internet users, broadband customers have the ability to reach virtually any Web site. Therefore, they can access any ISP's content via the Web. Not all content is free, of course; owners of many web sites restrict viewing to individuals who have paid a membership fee or a one-time charge to access specific content. But these charges are imposed by the web site, not the broadband provider. America Online, for example, offers a "Bring Your Own Access" package that provides access to AOL's content for customers who have another ISP. This service is available to customers who use either broadband or conventional dial-up service to access the Internet.

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<sup>5</sup> *Second Report*, paras. 252-54.

## 2. Choice of ISP for connection to Internet

Although broadband customers do not need an ISP to provide a dialup connection, they might still wish to choose which ISP provides the connection between the cable head-end (or other broadband provider's local facilities) and the Internet. Such a choice would be valuable if independent ISPs can provide the connection at a lower cost or at a higher level of quality (speed, reliability, etc.) than the broadband provider's own ISP. The broadband provider has strong incentives to ensure that this service is provided in a cost/performance combination that customers find most attractive – especially if the broadband provider itself faces competition.

### **B. Forms of open access**

There are several possible models for open access. All focus on ensuring that the customer can choose which ISP connects the local broadband plant to the Internet. That does not necessarily mean that customers will select an ISP solely on this basis. Broadband customers who are unaware that they could access their favorite ISP's content via the Web may believe that they are choosing a content provider as well. As a marketing strategy, an ISP might encourage this perception, or even offer different content to customers who choose direct access rather than Web access. In practice, therefore, open access could affect both types of services that ISPs provide broadband customers.

#### 1. Equal treatment

In the “equal treatment” model, broadband providers let all ISPs connect to their system on equivalent terms and conditions. In practice, this means that no independent ISP would connect on terms that are less favorable than those that the broadband provider offers its own ISP. Independent ISPs would pay a similar price to connect. Customers would be allowed to choose their ISP, and screen displays and other advertising could not give any preference to the broadband company's own ISP. If the broadband company chose to give customers one bill for the use of the broadband “pipe” and its ISP service, then the broadband company would also have to offer joint billing to all other ISPs. Prices, collocation arrangements, and other terms of interconnection would be determined by negotiation.

#### 2. First-screen parity and joint billing

Under this option, the broadband company would be required to let the customer choose an ISP from a list that appears when the customer first turns on the service. The display could not discriminate in any way that would advantage any particular ISP, including the broadband company's own ISP. The broadband company would also have to send customers a single bill that included charges from whatever ISP the customer chose.

The principal difference between this model and the “equal treatment” model is that broadband providers would have a definite obligation to offer first-screen parity and joint

billing. Under the “equal treatment” model, the broadband company would only have to do these things for independent ISPs if it chose to do so for its own ISP. Prices and other terms of compensation could still be determined by negotiation.

### 3. Regulated interconnection prices

The next step toward more comprehensive regulation would be for government to control the prices and other terms of compensation in contracts between broadband companies and independent ISPs.

### 4. Common carriage

Under a common carriage model, broadband providers would be required to offer interconnection to all ISPs and carry data between customers and all ISPs at reasonable rates. They could not discriminate against independent ISPs. This approach is similar to the way that incumbent local exchange carriers must treat long-distance telephone companies.

### 5. Unbundling and resale

The most comprehensive form of open access regulation would subject broadband providers to the same types of “unbundled network element” requirements that incumbent local exchange carriers face under the Telecommunications Act of 1996. In addition to obtaining interconnection and access, independent ISPs could lease elements of the broadband provider’s network so that they could market broadband service under their own brand name directly to customers.

## **IV. Is open access a desirable policy goal?**

Different commenters will no doubt answer this question differently. A principal reason is that diverse ideological perspectives, political concerns, and financial interests will lead different commenters to advocate different criteria for making the decision.

### **A. The consumer welfare criterion**

Consistent with the views of many economic researchers, the Regulatory Studies Program believes that the appropriate criterion is consumer welfare. A policy that maximizes consumer welfare is a policy that allows consumers to satisfy as many of their most highly-valued wants as possible, where the consumer’s own judgment establishes which wants are most important.<sup>6</sup> An economic system that maximizes consumer

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<sup>6</sup> Consumer welfare is also known as “economic efficiency.” We prefer the term consumer welfare, because it conveys the meaning in a way that is more intuitive to non-economists. To non-economists, “economic efficiency” often implies some concept of engineering or technological efficiency that is unrelated to the wants and desires of people. Although economic efficiency is, to economists, clearly different from engineering or technological efficiency, the difference is not always clear to non-economists, and “consumer welfare” more accurately conveys the appropriate meaning.

welfare is getting the greatest value out of the resources that the people in that system possess. Consumer welfare can be distinguished from a number of other criteria that various parties may propose, such as the welfare of the industry, the welfare of particular firms, advancement of various industrial policy objectives, or assistance to a particular “deserving” group of consumers at the expense of others.

The most practical way the Commission can promote consumer welfare is to promote competitive markets in which consumers can make their own choices. The competitive process is a means of discovering which products and services consumers most want, as well as the most effective ways of producing them. The purpose of competition is not just to give companies incentives to provide consumers with the combinations of price and quality that they most prefer, but also to give firms a means of discovering which combinations consumers most prefer.<sup>7</sup>

### **B. Does open access maximize consumer welfare?**

The most intellectually honest answer to this question is that in the broadband context, no one yet knows for sure. The only way to find out is to allow competition between open and closed systems, and see which one prevails in the marketplace.

The ultimate decision could go either way. A cable company or other broadband provider that faces competition has strong incentives to give customers access to the best possible ISP, regardless of whether the ISP is affiliated with the broadband provider. The broadband provider faces a classic “make or buy” decision, and the provider would only favor its own ISP if it believed that its own ISP would offer consumers the best combination of price and quality. If a competing ISP is better, then a broadband provider could most easily attract and retain customers by giving them access to that ISP. If customers differ widely in their preferences for cost and performance, then the broadband provider has a strong incentive to give customers a choice among multiple ISPs, or even a choice among all ISPs.

Whether open access benefits consumers thus depends critically on whether the broadband provider can offer a service that better satisfies customer preferences by using its own ISP, an independent ISP, or a multiplicity of independent ISPs. In addition, a move to open access will require additional investments in hardware and software on the part of broadband providers, most of whom built their systems on the assumption that they would offer only one ISP. Whether one considers the firm’s or the consumer’s perspective, these investments make no sense unless the benefits that consumers gain from a wider choice of ISPs exceed the costs of modifying cable systems to accommodate multiple ISPs. For these reasons, we cannot predict with certainty whether open access will win out in the marketplace.

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<sup>7</sup> Friedrich A. Hayek, “Competition as a Discovery Procedure,” in *New Studies in Philosophy, Politics, Economics, and the History of Ideas* (University of Chicago Press, 1978); David Harper, *Innovation and Entrepreneurship* (Routledge, 1995).



### **C. Research on the benefits of open access must be interpreted carefully**

This conclusion may appear to contradict a great deal of economic research in telecommunications and other regulated utilities which shows that open access regulation often lowers consumer costs, promotes innovation, and gives customers a wider variety of choices.<sup>8</sup> The contradiction is only apparent. Most research on the benefits of open access compares closed, integrated monopolies to a regime in which open access for some monopoly elements of an industry facilitates competition in other parts of the industry. It is no surprise that a move from integrated monopoly to partial competition improves consumer welfare.

But the broadband market is not monopolized.<sup>9</sup> Although cable and telephone companies have historically enjoyed government-protected monopolies for non-broadband services, the policy model for the future of these industries is clearly competition. Any type of open access regulation will, of course, apply in the future, not the past. Therefore, analogies from telephone service, natural gas, electricity, or similar regulated monopolies tell us little or nothing about the prospective benefits of open access in a competitive broadband market.

The only examples from other industries that might be analogous would be situations in which firms that already faced competition adopted (or were forced to adopt) open access. As a general rule, these will not be industries that have been subject to traditional monopoly regulation, because the existence of competition obviated the need for such regulation. Therefore, the Commission should be skeptical of the relevance of any examples of the benefits of open access imposed on regulated monopolies.

### **V. If open access is a desirable policy goal, what is the most appropriate means of achieving that objective?**

The Commission perceptively implies that if open access is unambiguously desirable, competitive pressures could lead broadband providers to offer open access even in the absence of a regulatory mandate.<sup>10</sup> Economic analysis supports this inference. There is no reason to compel open access if broadband is not monopolized, and there is substantial evidence that the broadband market is quite competitive.

#### **A. The only consumer welfare justification for imposing open access is monopoly**

Competitive markets tend to promote consumer welfare. Competition allows consumers to express their own desires by choosing among different providers. By allowing choice, competition also gives firms incentives to give consumers what they want at a reasonable

<sup>8</sup> See, for example, Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice* (Fairfax, VA: Mercatus Center, 1996).

<sup>9</sup> See section IV.A.2 below.

<sup>10</sup> *Notice of Inquiry*, paras. 34-36.

cost. More importantly, competition is a trial-and-error process that allows firms to experiment by offering different services and learning which ones gain consumer acceptance.

From a consumer welfare perspective, open access regulation may be justified only if monopoly constrains the competitive process. If a monopolist controls the only broadband “pipe” into homes or businesses, then the monopolist could have incentives to discriminate against independent ISPs.

The key justification for forced access regulation is monopoly control of facilities. The U.S. Supreme Court hinted at this in its January 1999 decision striking down some of the unbundled network element regulations the FCC promulgated under the Telecommunications Act of 1996. The Court stated that the FCC could not simply require local telephone companies to make all elements of their networks available to competitors. Rather, the FCC had to define criteria by which access to a piece of the network would be considered “necessary” for the competitor to offer its service.<sup>11</sup>

The Court did not explicitly state that the Commission could only mandate access to monopolized facilities, but much of antitrust jurisprudence does.<sup>12</sup> The antitrust cases confirm what commonsense economics suggests: if a facility or service is available from multiple competitors, there is no reason to compel access. Competing service providers will offer open access on their own initiative if they believe consumers want open access.

#### **B. The broadband market is not monopolized**

Fortunately, the broadband market shows many signs of intense competition.

It is true that cable currently has the largest market share, with about 80 percent of broadband subscribers. Several factors suggest, however, that cable has no monopoly.

First, the market is at a very early stage in its development and changing rapidly. Between 1998 and 1999, cable’s market share fell by 13 percentage points, from 93 percent to 80 percent. Cable’s share of the entire broadband market fell to 52 percent by June 2000, and cable’s share of the residential broadband market fell to 70 percent.<sup>13</sup>

Second, the market share data portray a very inaccurate picture of the competitive options actually available to customers. If we consider the available options, the market is more

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<sup>11</sup> *AT&T v. Iowa Utilities Board*, 525 US 366 (1999).

<sup>12</sup> The “essential facility” doctrine requires a monopolist to offer reasonable and nondiscriminatory access to the facility it monopolizes. “The doctrine’s principal requirement is that the facility be impractical or uneconomic to duplicate.” See Lawrence A. Sullivan and Ann I. Jones, “Monopoly Conduct, Especially Leveraging Power from One Product or Market to Another,” in Thomas M. Jorde and David J Teece (eds.), *Antitrust, Innovation, and Competitiveness* (Oxford University Press, 1992), p. 176.

<sup>13</sup> In 1998, cable had 350,000 out of 375,000 total broadband subscribers. (*Broadband Report 1999*) In 1999, cable had 2.3 million out of 2.86 million broadband subscribers. (*Second Report*) In June 2000, cable had 2.3 million out of 4.3 million broadband subscribers and 2.2 million out of 3.1 million residential broadband subscribers. (*High-Speed Services Report*).

competitive than the market share figures might seem to imply. In 1999, cable modem service was available to 49 percent of American households, and DSL was available to 25 percent. One-way broadband is also available nationwide via satellite, and a new venture will soon make 2-way broadband available via satellite. When multiple companies already have capacity installed, they have little choice but to compete if they expect to make a profit on their investments.

Third, the availability of competitive options is also expected to expand rapidly. Figures in the most recent FCC broadband report imply that cable modems will be available to 84 percent of households by the year 2004, with DSL available to 80 percent. Two-way satellite will essentially be available nationwide. Wireless will be available to between 13 and 34 percent of households.<sup>14</sup>

Fourth, all of these figures understate the extent of competition, because there are (or could be) multiple providers of each of these technologies in a given location. For example, new, competing cable “overbuilders” have targeted the nation’s 20 largest markets for entry and have raised \$10 billion in capital in the past two years.<sup>15</sup> The Commission’s second broadband report found multiple cable broadband and/or multiple DSL providers in close proximity, and sometimes overlapping, in three of the five locations chosen for case studies: Los Angeles County, CA, Waltham, MA, and Muscatine, IA.<sup>16</sup> The data in Appendix B to the report suggest that there might be multiple, overlapping cable and/or DSL providers in many zip codes serving much of the U.S. population, but the way the information is presented makes it impossible to draw reliable inferences about the extent of competition. Further analysis of the raw data, either by Commission staff or by outside researchers, could shed much-needed light on the state of competition in local broadband markets.

Of course, the broadband market is quite young. It is appropriate to note, as another commissioner recently did, that “the vast majority of small business and residential customers today – *regardless of their income level or where they live* – choose not to subscribe to advanced services.”<sup>17</sup> Given this reality, the evidence of vigorous competition is even more impressive. The Commission has been wise to avoid regulating against “problems that have yet to materialize in a market that has yet to develop,” in the words of the FCC’s chairman.<sup>18</sup>

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<sup>14</sup> Figures in this and the preceding paragraph are compiled from information in the FCC’s *Second Report*.

<sup>15</sup> Alan Breznick, “New Broadband Service Providers Scare Cable Industry,” *Communications Daily*, (September 13, 2000), p. 2

<sup>16</sup> *Second Report*, paras. 119-20, 143-46, and Appendix C, paras. 18-24.

<sup>17</sup> *Second Report*, Concurring Statement of Commissioner Harold Furchtgott-Roth.

<sup>18</sup> *Wall Street Journal* (March 24, 1999).

**C. The Commission should adopt a dynamic framework for analyzing the competitiveness of markets**

Since the broadband market is a young market experiencing tremendous flux, the Commission should take care to adopt an appropriate framework for competition analysis.

The Commission has had ample experience with competition analysis in recent years due to a series of telecommunications and cable mergers, but these mergers have often involved large competitors, with substantial assets already in place, using well-known technologies to provide familiar services that have often been regulated for decades. In contrast, the broadband market features an assortment of old, new, and yet-unknown competitors using a variety of new technologies to provide services whose true potential will only be discovered over time. The rapidly-changing nature of the broadband market suggests that the Commission should be especially sensitive to the issues raised by dynamic theories of competition that emphasize innovation and change.

Conventional competition analysis usually involves fairly straightforward applications of economic theories of actual and potential competition. The typical analysis of actual competition, entry barriers, and potential competition is conducted in a static framework that assumes production technology, marketing techniques, management methods, and consumer tastes are known and given. Even the developers of contestable market theory, which emphasizes the role sunk costs play as a barrier to entry, acknowledge that contestability theory says nothing about innovation and change. Rather, contestable market theory discusses how potential competitors employing the same technology as the incumbent can discipline the incumbent's behavior.<sup>19</sup>

When innovation and discovery are possible, conventional competition analysis overestimates the potential for market power. In dynamic markets, potential entrants can leapfrog an incumbent by offering superior products and services, lower prices, or creative contract terms. Sunk costs depreciate more rapidly – and more unpredictably -- because of ceaseless change. Potential competition, in the form of Schumpeterian "creative destruction," could be much more vigorous in spite of sunk costs.<sup>20</sup>

It is important to emphasize the breadth of phenomena that dynamic competition includes. For many people, the word "innovation" connotes new inventions or changes in physical production processes, and even a great deal of economics literature on innovation exhibits a narrow focus on "hardware" issues, such as patentable inventions.

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<sup>19</sup> William J. Baumol and Janusz Ordover, "Antitrust: Source of Dynamic and Static Inefficiencies?" In *Antitrust, Innovation, and Competitiveness* edited by T. Jorde and D. Teece, (New York: Oxford, 1982): 82-97.

<sup>20</sup> Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper, 1942); Shelby Hunt, *A General Theory of Competition* (New York: Sage, 2000); Jerry Ellig (ed.), *Dynamic Competition and Public Policy: Technology, Innovation, and Antitrust Issues* (New York: Cambridge University Press, 2001).

In an economic sense, however, innovation comprises any type of change, including changes in marketing methods, management philosophies, or contracting strategies.<sup>21</sup>

To assess whether the broadband market is monopolized, it is critical that the Commission determine whether the market is in long-run equilibrium or in the midst of a continuous process of change. If the former, then conventional competition analysis, which focuses on counting competitors, calculating market shares, and assessing barriers to entry, may be appropriate. If the latter, then sunk costs might not be so formidable a barrier to entry after all, and inferences about the existence of monopoly based on a traditional analysis of market shares and entry barriers will be misleading.

The available evidence suggests that the broadband market is far from equilibrium and will be for some time. Even if measures of market shares or analysis of entry barriers suggested that broadband was monopolized, it is unlikely that such a monopoly would last for a substantial period of time. Therefore, the Commission would be fully justified in continuing its cautious, market-based approach to open access in broadband.

#### **D. Do the benefits of regulation outweigh the costs?**

Even if a broadband provider possesses significant market power that is likely to last for a long time, there is no guarantee that regulation will improve on an unregulated monopoly. A vast literature in economics and political science documents that regulation itself can impose significant costs. These costs include the cost of compliance, the costs of litigation and lobbying to shape or circumvent the regulation, and the perverse incentives created by many forms of price regulation.<sup>22</sup> The costs are likely to be greater

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<sup>21</sup> Sunk construction costs, for example, need not deter entry if the entrant can obtain assurances that it will capture enough of the market to earn a profit. The prospective entrant can bid for and sign up enough of the market to make its project profitable, even if such competition for the market imposes losses on the incumbent. The most straightforward way of accomplishing this is through contracting with customers, and this is in fact what some potential entrants have done. Richard Posner pointed this out years ago in regard to cable television. See R. Posner, "The Appropriate Scope of Regulation in the Cable Television Industry," 3 *Bell J. of Econ.* 98 (1972) at 112. This strategy was also employed by a federally-regulated gas pipeline in Southern California that sought to expand into Northern California in competition with a state-regulated utility. The only truly sunk costs were those associated with contracting; counting construction costs as sunk costs overstated the magnitude of the entry barrier by a factor of 20! See Jerry Ellig, Jeff Kaufman, and Tom Rustici, "When Do Sunk Costs Prevent Entry? The Case of Gas Pipelines," manuscript, George Mason University (March 17, 1995).

<sup>22</sup> For a comprehensive catalogue of the costs and benefits of regulation see Jay Cochran, "Toward a Taxonomy of Regulatory Costs," Regulatory Studies Program Working Paper (June 1, 2000).

the more extensive the regulation. For example, imposing the same types of unbundled network element requirements on cable companies that incumbent local exchange carriers face would likely lead to significant litigation and lobbying costs and create incentives for both cable companies and independent ISPs to game the system. Alternatively, a requirement that broadband providers simply provide access to all ISPs on the same, privately-negotiated terms would entail more modest costs.

Mandatory open access is likely to improve consumer welfare only if there is a single broadband supplier, no potential entrants, significant barriers to entry, no significant potential for further innovation, and the benefits of regulation outweigh the accompanying costs. After taking all of these factors into consideration, RSP concludes that mandatory open access would not improve consumer welfare.

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For a sample of the economics literature outlining the perverse incentives created by regulation, see Thomas W. Hazlett, "Prices and Outputs Under Cable TV Reregulation," *Journal of Regulatory Economics* 12:2 (Sept. 1997): 173-97; Hazlett, "Spectrum Flash Dance: Eli Noam's Proposal for 'Open Access' to Radio Waves," *Journal of Law & Economics* 41:2 (Oct. 1998): 805-20; Hazlett et. al., "Was the Fairness Doctrine a 'Chilling Effect'? Evidence from the Postderegulation Radio Market," *Journal of Legal Studies* 26:1 (Jan. 1997): 279-301; Leon Courville, "Regulation and Efficiency in the Electric Utility Industry," *Bell Journal of Economics* 5 (Spring): 53-74; Paul M. Hayashi and John M. Trapani, "Rate of Return Regulation and the Regulated Firm's Choice of Capital-Labor Ratio: Further Empirical Evidence on the Averch-Johnson Effect," *Southern Economic Journal* 42 (January 1976): 384-97; H. Craig Petersen, "An Empirical Test of Regulatory Effects," *Bell Journal of Economics* 6 (1975): 111-26; Robert M. Spann, "Rate of Return Regulation and Efficiency in Production: An Empirical Test of the Averch-Johnson Thesis," *Bell Journal of Economics* 5 (Spring): 8-52; E. Ray Canterbury, Ben Johnson, and Don Reading, "Cost Savings from Nuclear Regulatory Reform: An Econometric Model," *Southern Economic Journal* (Jan. 1996): 554-66; George J. Stigler and Claire Friedland, "What Can Regulators Regulate? The Case of Electricity," *Journal of Law & Economics* 5: 1-16; Thomas G. Moore, "The Effectiveness of Regulation of Electric Utility Prices," *Southern Economic Journal* 36 (April): 365-75.

For discussions of the political influence costs associated with regulation, see Michael Crew and Charles Rowley, "Toward a Public Choice Theory of Monopoly Regulation," *Public Choice* 57 (1988): 49-67; James Buchanan, Robert Tollison, and Gordon Tullock, *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A&M University Press, 1980); Thomas W. Hazlett, "Assigning Property Rights to Radio Spectrum Users: Why Did FCC License Auctions Take 67 Years?," *Journal of Law & Economics* 41:2 (Oct. 1998): 529-75; Hazlett, "Oak Leaves and the Origins of the 1927 Radio Act: Comment," *Public Choice* 95:3-4 (June 1998): 277-85; Hazlett, "The Cost of Rent-Seeking: Evidence from Cellular Telephone License Lotteries," *Southern Economic Journal* 59:3 (Jan. 1993): 425-35; Hazlett, "The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California," *Economic Inquiry* 29:2 (April 1991): 275-96.

## **VI. Should a uniform framework apply?**

The Commission also asks whether it should apply a uniform regulatory framework to all broadband providers.<sup>23</sup> The very fact that the Commission asks this question provides yet additional evidence about the competitiveness of the broadband market. The uniformity issue arises precisely because many parties believe that asymmetrical regulation gives some firms or technologies a competitive advantage over others. If the market were truly monopolized, the issue would be moot. In a sense, the Commission could regard the volume of paper, legal talent, and other resources that various parties devote to arguing over this question as another indicator that actual and potential competition among broadband providers is robust.

RSP believes that the Commission's market-based approach to open access in broadband is appropriate for all broadband providers – including incumbent local exchange carriers. Since these broadband providers face competition from cable, satellite, and wireless, there is no consumer interest justification for subjecting them to a greater degree of access regulation than their competitors.

This statement should not be taken to imply a blanket endorsement of a uniform open access regulatory policy under all circumstances. For example, consumers are arguably better off under the current asymmetric policy than they would be if all broadband providers were subject to the same open access regulations as the incumbent local exchange carriers. In this case, asymmetric regulation permits at least part of the industry to develop unencumbered by unnecessary access regulations. Consumers have a choice among providers, some of whom are not subject to the regulations, and so consumers have a chance to avoid some of the costs of the regulations.

## **VII. Conclusion**

The broadband market shows many signs of robust, dynamic competition. In a competitive broadband market, providers have strong incentives to offer whatever form of access maximizes the value of broadband Internet service to consumers. It is not clear whether the open model, the closed model, or some mixed model will emerge victorious. Nevertheless, as long as broadband remains competitive, we can be confident that the winning business model(s) will be those that best satisfy consumer desires. Therefore, the Commission's market-based approach to broadband open access is appropriate for all broadband providers.

In considering whether to require open access in broadband, the Commission risks being drawn into decisions that are more appropriately made in competitive markets through private, voluntary negotiation. Before heading down this road, the Commission would do well to consider the experience of a regulatory body that has been moving in the opposite direction. The Surface Transportation Board has limited authority to regulate railroad rates and terms of service, but even this small amount of regulatory authority gives some

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<sup>23</sup> *Notice of Inquiry*, para. 43.

industry participants an irresistible temptation to expend resources in an attempt to displace negotiation with regulation. One Board member lamented:

It is unfortunate that parties to this proceeding are unwilling to reach negotiated settlements on these issues.

More unfortunate is that such reliance on government to solve private-sector problems encourages a cycle of dependence that weakens further the parties' negotiating resolve and encourages a return to third-party intervention that, as history records, was equally detrimental to both railroads and their customers.

Indeed, without a negotiated settlement among the parties this issue likely is headed for the lap of Congress where solutions too often are hastily drawn, politically motivated and for a long-time afterward insulated from change even by private agreement of the parties who had the dispute.

Whatever the eventual outcome, the fact remains that the parties have knocked loudly upon our door, ignored subsequent admonitions to settle these matters privately among themselves and continued to beg for government intervention...

...I continue to believe that more efficient solutions to all shipper-carrier disputes are to be achieved in the marketplace and through direct negotiations without the intrusion of government. Perhaps my admonition in favor of negotiation should include this paraphrase from Isaiah 1:18-20: "Come let us reason together, or ye shall be devoured by the sword."<sup>24</sup>

The Commission should send the same message to the contesting parties in the debate over broadband open access.

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<sup>24</sup>Comments of Commissioner Owen in the Bottleneck Cases, Surface Transportation Board Nos. 41242, 41295, and 41626 (December 27, 1996).



## Appendix I

### RSP Checklist

#### FCC Notice of Inquiry on Broadband Open Access

Element	Commission Approach	RSP Comments
1. Has the Commission identified a significant market failure?	In the Notice of Inquiry, the FCC withholds judgment on whether there is a market failure that would justify mandatory open access.  <b>Grade: A</b>	The Commission's previous broadband reports, as well as its market-based approach toward open access broadband provided via cable, satellite, and wireless, suggests that there is no market failure that would justify new regulations.
2. Has the Commission identified an appropriate federal role?	The Commission has jurisdiction to examine this issue as a result of previous court decisions that preclude state and local governments from imposing their own open access regulations on cable companies.  <b>Grade: B</b>	The issue clearly involves nationwide, and indeed international, transport of data. Whether it is appropriate for any level of government to mandate open access in a competitive industry is an open question, and the Commission has left this question open pending development of the factual record.
3. Has the Commission identified alternative approaches?	Yes. The Commission has explicitly asked for comments on a variety of possible approaches, including a market-based approach.  <b>Grade: A</b>	The Commission seems genuinely open to all possibilities.

Element	Commission Approach	RSP Comments
4. Does the Commission attempt to maximize net benefits?	<p>The Notice of Inquiry says nothing explicitly about cost/benefit analysis, and there is no indication that the Commission would necessarily seek to maximize net consumer benefits.</p> <p><b>Grade: C</b></p>	<p>Because the Commission approaches many issues under a vaguely-defined “public interest” standard, there is no guarantee that the Commission will seek to maximize net consumer benefits.</p>
5. Does the proposal have a strong scientific or technical basis?	<p>Economic analysis suggests that access regulation is not warranted in a competitive market.</p> <p><b>Grade: B</b></p>	<p>The Commission appears disposed to giving the economic analysis a fair hearing.</p>
6. Are distributional effects clearly understood?	<p>There is no discussion indicating that different consumers might find different access solutions desirable. Commission’s principal distributional concern is that everyone has access to broadband regardless of income level.</p> <p><b>Grade: F</b></p>	<p>Mandatory access entails additional costs for cable companies, which will likely be passed on to customers. The policy will force customers who are happy with the cable company’s ISP (and have no intention of switching) to subsidize customers who want to choose other ISPs. Whether this is a large or small subsidy is unclear.</p>

Element	Commission Approach	RSP Comments
7. Are individual choices and property impacts understood?	<p>Regulation of communications is pervasive. The mere fact that facilities are privately owned presents no barrier to open access regulation.</p> <p><b>Grade: C</b></p>	<p>The access question hinges on a purely utilitarian calculation. If broadband facilities are monopolized, then regulators can justify imposing forced access by invoking well-established common carrier principles that attenuate private property rights.</p>

**Federal Communications Commission**

**The FCC Acknowledges Receipt of Comments From ...  
Wendy L. Gramm and Susan E. Dudley  
...and Thank You for Your Comments**

Your Confirmation Number is: '20001116707656 ' 1

Date Received: Nov 16 2000

Docket: 00-185

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